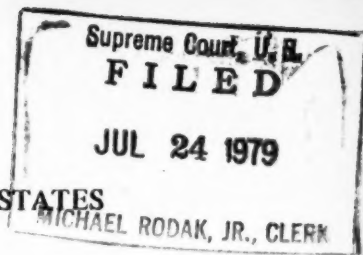


IN THE
SUPREME COURT OF THE UNITED STATES
OCTOBER TERM, 1979



NO. **79-115**

POLISHING MACHINE SYSTEMS, INC.,
JOHN A. TRICOLI, JR.
HELEN TRICOLI, and
NICHOLAS DANIELS,

Petitioners

v.

RICHARD E. COFFIN,

Respondent.

PETITION FOR WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE FOURTH CIRCUIT

W.H.C. Venable
Michael S. Shelton
COHEN, ABELOFF & STAPLES, P.C.
207 West Franklin Street
Richmond, Virginia 23220

TABLE OF CONTENTS

	<u>Page</u>
TABLE OF CASES	ii
OPINIONS BELOW.....	1
JURISDICTION.....	2
QUESTION PRESENTED.....	2
STATUTORY PROVISIONS INVOLVED.....	3
STATEMENT OF THE CASE.....	4
STATEMENT OF MATERIAL FACTS.....	4
RULINGS BELOW.....	6
ARGUMENT IN SUPPORT OF GRANTING THE WRIT.....	8
CONCLUSION.....	15
APPENDIX I: DISTRICT COURT OPINION (July 28, 1977).....	17
APPENDIX II: CIRCUIT COURT OPINION (April 25, 1979).....	18

TABLE OF CASES

Page

Accord. Emisco Industries, Inc. v. Pro's Inc., 543 F.2d 38 (7th Cir. 1976)	13, 14
Polikoff v. Levy, 55 Ill. App. 2d 229, 204 N.D. 2d 807, <u>cert. denied</u> , 382 U.S. 903 (1965).....	15
Romney v. Richard Prows, Inc. 289 F.Supp. 313 (D. Utah 1968).....	15
Securities & Exchange Commission v. Howey Co., 328 U.S. 293 (1946).....	6, <u>Id.</u>
United Housing Foundation, Inc. v. Forman, 421 U.S. 837 (1975).....	6, <u>Id.</u>

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The petitioners respectfully request that a writ of certiorari issue to review the judgment and opinion of the United States Court of Appeals for the Fourth Circuit entered in this matter on April 25, 1979.

OPINIONS BELOW

The opinion of the Court of Appeals, whose judgment is herein sought to be reviewed, is reported at 596 F2d 1202 and is

reprinted in the Appendix to this Petition beginning at page 13. The Order of the United States District Court for the Eastern District of Virginia, Richmond Division, dated July 28, 1977 which dismissed the respondent's complaint for lack of jurisdiction and for failure to state a claim upon which relief can be granted is reprinted in the Appendix to this Petition beginning at page 21.

JURISDICTION

The jurisdiction of this Court is invoked pursuant to 28 U.S.C. §1254 (1). The judgment of the Court of Appeals was entered on April 25, 1979.

QUESTIONS PRESENTED

The question presented is whether the sale of an interest in a corporation by means of the transfer of stock certificates with a concomitant right and obligation to participate in the management of the corporation is a sale of "securities" within the purview of the Securities Act of 1933 and the Securities Exchange Act of 1934.

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STATUTORY PROVISIONS INVOLVED

This case involves the definition of the term "security" as set forth in the Securities Act of 1933 and the Securities Exchange Act of 1934. The Securities Act of 1933, 15 U.S.C. § 77b(1) (1971) provides as follows:

The term "security" means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, or, in general, any interest or instrument commonly known as a "security" or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

Similar provisions are found in the Securities Exchange Act of 1934, 15 U.S.C. §78c(10) (1971) which provides as follows:

The term "security" means any note, stock, treasury stock, bond debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit, for a security, or in general, any instrument commonly known as a "security", or any certificate of interest or participation in,

temporary or interim certificate for, receipt for, or warrant or right to subscribe to or purchase, any of the foregoing; but shall not include currency or any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited.

STATEMENT OF THE CASE

This is a civil action brought by Richard E. Coffin ("Respondent"), in the United States District Court for the Eastern District of Virginia, Richmond District, to recover compensatory and punitive damages for misrepresentations allegedly made to him in connection with his purchase of stock in Polishing Machine Systems, Inc. The district court dismissed the action for lack of federal jurisdiction and for failure to state a claim upon which relief can be granted. The action was dismissed upon motion made by the petitioners pursuant to Rule 12(b) (1); (b) (6) of the Federal Rules of Civil Procedure. The United States Court of Appeals for the Fourth Circuit reversed and remanded in an option entered on April 25, 1979.

STATEMENT OF MATERIAL FACTS

The claim of the respondent was dismissed by the district court

upon motion which accepted as true the allegations set forth in the complaint. These allegations show that the respondent was induced to purchase a 50% interest in the common stock of Polishing Machine Systems, Inc. for the sum of \$30,000.00. Under the agreement which effected the transaction, the respondent was to share on an equal basis in the overall operation of Polishing Machine Systems, Inc., devoting his full time to duties as executive vice president of the corporation. As alleged in the complaint, Mr. Coffin became "an active participant in the business and affairs of Polishing Machine Systems, Inc. as required by the Agreement." Complaint, ¶12.

After subsequently gaining access to the corporation's books, Mr. Coffin learned that certain representations alleged to have been made to him during the negotiations were materially false and misleading. Specifically, the allegations provide that Mr. Coffin discovered that Tricoli had converted corporate assets to his own use and left Polishing Machine insolvent. Mr. Coffin then brought this action in the district court to recover damages under the federal securities acts, the Virginia blue sky statute, and the common law of fraud.

RULINGS BELOW

In an Order entered July 28, 1977, the district court granted the petitioners' motion to dismiss for lack of jurisdiction pursuant to Fed. R. Civ. P. 12(b) (1) and for failure to state a claim upon which relief can be granted pursuant to Fed. R. Civ. P. 12(b) (6).

In a Memorandum Opinion filed the same day, the district court ruled that no federal question existed under the securities laws because the investment made by Mr. Coffin was not a "security" as defined by decisions of the United States Supreme Court. The district court noted that "the law must look to the substance and not the form" of a transaction involving stock. Following the rulings of this Court in Securities & Exchange Commission v. Howey Co., 328 U.S. 293 (1946) and United Housing Foundation, Inc. v. Forman, 421 U.S. 837 (1975), the district court concluded that even though the form of the transaction utilized stock which had all of the attributes of ordinary stock, the substance of the transaction was not the sale of securities but the sale of a one-half interest in an ongoing business for which the purchaser was not to be an investor but rather an

active and significant participant. Noting that Mr. Coffin purchased a full one-half interest in the business, agreed to work and devote his full time and effort to its affairs, served as an officer, and shared on an equal basis in the management of the company, the district court found that Mr. Coffin was not induced to invest money in the hope of deriving a profit from the work of others and hence the transaction did not involve the sale of a security.

The United States Court of Appeals for the Fourth Circuit reversed the district court's decision and remanded the case for further proceedings in an opinion entered April 25, 1979. The circuit court found that when a transaction involves stock, there is a strong presumption that the securities statutes apply. The court stated that the question of whether an investor will derive his profit partly from his own efforts is to be considered only when there is some showing that ordinary corporate stocks are other than what they appear to be, such as interests not easily recognized as securities in the capital market. Because the alleged transferred interest involved ordinary corporate stock, the court of appeals concluded no other inquiry was necessary

or permissible under the federal securities acts. Therefor, the district court's decision was reversed and the case was remanded.

ARGUMENT IN SUPPORT OF GRANTING THE WRIT

The decision of the United States Court of Appeals for the Fourth Circuit in holding that the transaction in dispute is within the purview of the Securities Act of 1933 and the Securities Exchange Act of 1934, is a federal question decision made in a way probably in conflict with applicable decisions of the United States Supreme Court.

In holding that the transaction in question involved a security, the circuit court ignored the definitions for a security set forth in two decisions of this Court, namely, Securities and Exchange Commission v. Howey Co., 328 U.S. 293 (1946) and United Housing Foundation, Inc. v. Forman, 421 U.S. 837 (1975). Rather than apply the flexible approach enunciated by this Court in Forman, the circuit court utilized the wooden approach advanced by the respondent.

Mr. Coffin initially argued before both the district and

circuit courts that because the literal definition of "security" includes "any stock" and because the stock sold to Mr. Coffin has "all the characteristics one usually associates with stock", that the transaction set forth in the complaint clearly fell within the purview of the federal legislation. This argument runs contrary to the rationale of Forman as well as numerous decisions from other circuits.

In United Housing Foundation, Inc. v. Forman, *supra*, the plaintiffs purchased shares of stock in a housing co-op as pre-requisites to becoming tenants in the project. When certain false and misleading representations were discovered in the information bulletin used to attract the tenants, the tenants sought relief from the federal courts under the same securities acts relied upon by Mr. Coffin. This Court quickly rejected the argument that a stock is a stock is a stock. A transaction is not to be considered a security transaction under the protection of the federal securities acts simply because the transaction is evidenced by the sale of shares called "stock" even though the statutory definition of security includes the words "any ... stock." 421 U.S. at 848. Instead, in searching for the meaning and scope of the word "security," a court must disregard the form of the trans-

action and look to its substance.

The same principle was applied to a converse situation in Securities & Exch. Com. v. Howey, Co., supra. In Howey, the Securities and Exchange Commission sought to halt the offering of units in a citrus development. Although the transaction did not fall within the literal definition of a "security," this Court disregarded the name given to the transaction but looked to its substance.

Contrary to the circuit court's ruling, therefore, the mere fact that the transaction set forth in Mr. Coffin's complaint involved the transfer of shares of the corporation's stock does not per se bring the transaction within the purview of the federal acts. Mr. Coffin must demonstrate that the substance of the transaction, and not its form, constitutes a sale of securities.

The district court carefully considered the allegations in Mr. Coffin's complaint, the agreement between the parties dated February 15, 1976 and the descriptive report prepared by the defendants and determined that the substance of the transaction alleged in the complaint removed it from the purview of the federal legislation. To determine the appropriate standard

by which the substance of the transaction was to be measured, the district court again looked to the decisions in Forman and Howey.

In Howey, the respondents owned large tracts of citrus acreage which were planted annually. Approximately one-half of the acreage was kept by the respondents and the other half was offered to the public. Each purchaser was offered a land sales contract and a service contract for the harvesting and marketing of the crops. Looking to the substance of the transaction to determine whether it was within the protection of the federal securities acts, this Court stated: "The test is whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others." 328 U.S. at 301. In finding that the transaction in Howey came within the spirit if not the letter of the federal acts, this Court noted that the purchasers had no desire to occupy the land or to develop it themselves. The purchasers were attracted solely by the prospects of a return on their investment not a return on their own efforts. The purchasers were to provide the capital and share in the earnings and profits;

the promoters were to manage, control and operate the enterprise.

The same test was applied by this Court in Forman. Quoting from its earlier opinion in Howey, this Court expanded the application of the Howey test to situations other than investments contracts.

We perceive no distinction, for present purposes, between an "investment contract" and an "instrument commonly known as a security." In either case, the basic test for distinguishing the transaction from the other commercial dealings is

"whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others."
[citation omitted]

The test, in shorthand form, embodies the essential attributes that run through all of the Court's decisions defining a security. The touchstone is the presence of an investment in a common venture premised on a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others. 421 U.S. at 852.

In Forman, this Court found that the purchasers were attracted solely by the prospect of acquiring a place to live, and not by financial returns on their investment. The opinion noted:

What distinguishes a security transaction - and what is absent [in the situation of Forman] is an investment where one parts with his money in the hope of receiving profits from the efforts of others,

and not where he purchases a commodity for personal consumption or ... for personal use
421 U.S. at 858.

The key factor in both Howey and Forman was whether the purchaser could be fairly characterized as an "investor," attracted by the prospects of a return on his investment of money and looking to derive profits from the efforts of others or whether the purchaser could be fairly characterized as a "participant," attracted by the prospects of a return on the investment of his time and effort and looking to derive profits from his own efforts. Accord. Emisco Industries, Inc. v. Pro's Inc., 543 F.2d 38 (7th Cir. 1976). This Court has re-iterated on numerous occasions that the purpose of the securities acts is to protect the interest of investors. 421 U.S. at 850 (emphasis added). In judging situations as presented in Howey, Forman and the instant case, courts must look at the economic realities to determine whether the purchaser is to be an "investor" or "participant."

Applying this well-defined test to the facts in the instant case, the district court easily determined that Mr. Coffin was not a mere investor. Judge Warriner found that Mr. Coffin was not really buying shares of stock; he was buying a half interest in an ongoing

business with a concurrent right and obligation to participate in its management as an equal partner. Mem. op. at 3. The Court reviewed extensively the agreement between the parties dated February 15, 1976 which provided that Mr. Coffin was to "share on an equal basis in the overall operation of Polishing Machine Systems, Inc.," was to assume a position as officer of the corporation and was to "use [his] best efforts and full time in the day to day overall management of the company."

Mr. Coffin in his complaint, concedes that the substance of the transaction was a 50-50 partnership; he was "to become an active participant in the business and affairs of PMS, as required by the Agreement." In fact, Mr. Coffin assumed the duties of executive vice president of PMS in May of 1976. From these facts, the district court concluded that the transaction set forth by Mr. Coffin did not come within the securities acts. The plaintiff was not seeking a profit or return solely from the "entrepreneurial or managerial efforts of others." Instead, he bought himself a job with the company and assumed an official position as executive vice president with 50-50 managerial right.

Mem. op. at 6.

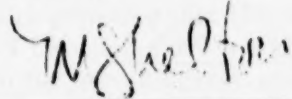
An analysis similar to that being urged by the respondents has been employed by various circuits in interpreting the term "note" as contained in the securities acts. See e.g., Emisco Industries Inc. v. Pro's Inc., 543 F.2d 38 (7th Cir. 1976). See also Romney v. Richard Prows, Inc., 289 F. Supp 313 (d. Utah 1968); Polikoff v. Levy, 55 Ill. App. 2d 229, 204 N.D. 2d 807, cert. denied, 382 U.S. 903 (1965). Applying the test enunciated by this Court in Howey, these courts have looked to the substance of each transaction rather than merely accept at face value that the instrument employed in the transaction comes within the literal coverage under the securities acts. Clearly, the Howey standard has been expanded beyond merely "investment contracts" and should be employed in this instance as was done by the district court.

CONCLUSION

The failure of the circuit court to apply the Howey test in the instant case runs contrary to the prior decisions of this Court and other circuit courts and provides strong reason for the granting of the writ requested by the petitioners. The issue raised herein is of greater importance and requires further clarification by

this Court. Accordingly, the petitioner requests that this matter be given further consideration on writ of certiorari.

Respectfully submitted,

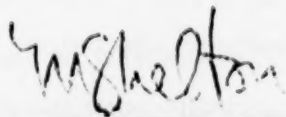


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Counsel for Petitioners

CERTIFICATE

I hereby certify that on the 24th day of July, 1979, a true and correct copy of the foregoing Petition for Writ of Certiorari was hand delivered to Stuart W. Settle, Esquire, 200 West Franklin Street, Richmond, Virginia, 23220, counsel for respondent.



Michael S. Shelton

IN THE UNITED STATES DISTRICT COURT
FOR THE EASTERN DISTRICT OF VIRGINIA
RICHMOND DIVISION

RICHARD E. COFFIN :

v. :

JOHN A. TRICOLI, JR., et al :

CIVIL ACTION
NO: 77-0318-R

MEMORANDUM

This matter is before the Court on defendants' motions of 5 July 1977 pursuant to Fed. R. Civ. P. 12(b) (1), 12(b) (6) to dismiss the above-styled action for lack of jurisdiction and for failure to state a claim upon which relief can be granted. As plaintiff has filed a responsive brief to these motions and defendants have filed their rebuttal brief, the motions to dismiss are ripe.

A summary of the facts relevant to this motion as alleged in plaintiff's complaint is substantially as follows: Defendant Mr. Tricoli, president of defendant Polishing Machine Systems, Inc., (hereinafter PMS) a Virginia corporation, approached plaintiff in November 1975. Plaintiff at that time was operating a service station in New York State. Defendant induced plain-

tiff to become an "area distributor" of PMS products. The fee charged for the "distributorship" was \$3,500.

A few months later defendant Mr. Tricoli, defendant Mrs. Tricoli, and defendant Mr. Daniels, attorney for defendant PMS, met with plaintiff for the purpose of inducing plaintiff to purchase for \$30,000 a 50% interest in the unregistered common stock of PMS. Shortly afterward plaintiff entered into an agreement with defendant Mr. Tricoli setting forth the terms of the \$30,000 stock purchase, one of which was that plaintiff, as executive vice-president, was to share on an equal basis in the overall operation of PMS. Some several months after gaining access to the books and accounts of PMS, plaintiff determined that the representations made to him had been materially false and misleading and, in fact, PMS was in a position of insolvency. Plaintiff is now suing for both compensatory and punitive damages.

It is defendants' position that the Court lacks jurisdiction in this matter as the Securities Act of 1933 and the Securities and Exchange Act of 1934 do not grant jurisdiction to federal courts unless there has been a fraudulent sale of a security

as defined by those Acts. Defendants argue that the transaction described by the plaintiff does not fall within the definition of a security and, hence, plaintiff's complaint fails both for lack of jurisdiction and for failure to state a claim upon which relief can be granted.

In support of their position, defendants cite the recent case of United Housing Foundation, Inc. v. Forman, 421 U.S.837 (1975) in which the Supreme Court held that the mere sale of shares called "stock" is not conclusively a security transaction within the coverage of the Security Acts simply because the statutory definition of a security includes the words "any... stock." Instead, in searching for the meaning and scope of the word "security" as used in the Securities Acts, courts should disregard form and look to the substance of the transaction. 421 U.S. at 849. The High Court went on to state that a security involved "the presence of an investment in a common venture premised on a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts, of others." 421 U.S. at 853 (emphasis added).

Plaintiff argues that since what defendants sold to him

was clearly, unequivocally, completely, and without modification or limitation, shares of stock then the Act must apply without regard to any other consideration. He points out that the decision in Forman is inapposite since, though there the instrument was called "stock" the reality was that it was not stock since it lacked most or all the significant attributes of stock. By contrast, the allegations of the complaint and the undeniable fact is that in this case the investment by plaintiff is represented by shares of stock to which are attached all or substantially all the attributes generally associated with that term. The Court must determine whether plaintiffs' straightforward and direct reading of the statute is consonant with the teaching of the decided cases.

Repeatedly, the law is laid down in this area that courts are to look to substance and not to form. The substance of the transaction alleged in the complaint is that plaintiffs bought a half-interest in the business along with the right to participate 50-50 in its management. Further, they proceeded to exercise that ownership and management. The fact that the transfer of the ownership interest and the management right took the form of the sale of stock does not alter the substance.

Nor does it alter the fact that though the form of the sale was through stock the investment was not made for the purpose of seeking a profit or return solely through the work of others. The offer of the sale of the stock was contained in language to the effect that defendant Mr. Tricoli does, "hereby offer unto Richard E. Coffin a 1/2 (one-half) interest of Polishing Machines Systems, Inc. That is a full 50-50 agreement. The purchase price for said interest, the sum of \$30,000."

The contract goes on to say that, "[u]pon acceptance of this agreement, Mr. Coffin is to share on an equal basis in the over-all operation of Polishing Machine Systems, Inc.. and all other directly related and wholly owned subsidiaries."

Paragraph six of the agreement provided "Tricoli and Coffin will at all times use their best efforts and full time in the day to day overall management of the company, following through with agreed company plans, policy and standard operation.

Paragraph seven provided for plaintiffs and Mrs. Coffin to assume positions as officers of the corporation and, finally, in paragraph ten the question of the issue of stock is dealt with.

It reads as follows, "Upon acceptance of this agreement, the shares representing this 50-50 agreement to be immediately issued."

The substance of the investment made by plaintiff is as set forth in the agreement from which the excerpts above are taken. Since the business was a corporation, the form of the purchase of the one-half interest and the assumption of one-half management rights was through the sale of stock. The law must look to the substance and not to the form. The question, then, is where the substance of a business transaction is the sale of an interest in a corporation with a concomitant right and obligation to participate in the management, are the certificates of stock issued to represent the transfer of that ownership interest "stock" within the meaning of Section 2(1) of the Securities Act of 1933?

That the name given to the investment instrument is not to be given a wooden meaning is made clear by Securities & Exch. Com. v. Howey Co., 328 U.S. 293 (1946). Howey discusses and defines an "investment contract" within the meaning of Section 2(1) of the Securities Act of 1933. On pages 297-299, in

discussing the meaning, the Court points out that at common law "an investment contract...came to mean a contract or scheme for 'the placing of capital or laying out of money in a way intended to secure income or profit from its employment.' " Omitting citations, the Court went on to say:

This definition was uniformly applied by State courts to a variety of situations where individuals were led to invest money in a common enterprise with the expectation that they would earn a profit solely through the efforts of the promoter or of someone other than themselves. [328 U.S. at 298 (emphasis added)].

The Court defined an investment contract for purposes of the Security Act as meaning:

[A] contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party, it being immaterial whether the shares in the enterprise are evidenced by formal certificates or by nominal interests in the physical assets employed in the enterprise. [328 U.S. at 298, 299.]

The Supreme Court observed that this definition:

[P] ermits the fulfillment of the statutory purpose of compelling full and fair disclosure relative to the issuance of 'the many types of instruments that in our commercial world fall within the ordinary concept of a security.... It embodies a flexible rather than a static principle, one that is capable of adaptation to

meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits.' [328 U.S. at 299 (emphasis added)].

Finally, the Supreme Court observes that:

[T]he test is whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others. If that test be satisfied, it is immaterial whether the enterprise is speculative or nonspeculative or whether there is a sale of property with or without intrinsic value. [328 U.S. at 301].

Though the Supreme Court in Howey consistently used the term "investment contract" it is clear that the definition used is applicable to "a variety of situations," "whether...evidenced by formal certificates or by nominal interest," for "many types of instruments," effectuating "countless and variable schemes." Thus, this Court is constrained to apply the definition to all securities, all devices and schemes, all forms or manners in which one may be induced to invest money in the hope of deriving a profit from the work of others. Even though the security be clearly, unequivocally and without quibble a share of stock nevertheless, if it does not represent an interest in an enterprise from which the investor seeks to derive a profit solely from the work of others then it is not "stock" for purposes of the Act no matter

what its efficacy as stock for other purposes may be.

The premise that in Howey the Supreme Court was not defining the narrow concept of an "investment contract" but was instead trying to define the "countless and variable schemes devised by those who seek the use of money of others on the promise of profits" is made clear by its further discussion in Forman, supra. The Court held in Forman that the mere naming of a piece of paper as "stock" did not make it stock for the purposes of the Act. 421 U.S. at 848. This distinction was emphasized when the Court said that previous decisions had:

[M]ade clear that [the Court] was not establishing an inflexible rule barring inquiry into the economic realities underlying a transaction. On the contrary, the Court intended only to make the rather obvious point that, in contrast to the instrument before it which was not included within the explicit statutory terms, most instruments bearing these traditional titles are likely to be covered by the statutes. In holding that the name given to an instrument is not dispositive, we do not suggest that the name is wholly irrelevant to the decision whether it is a security. There may be occasions when the use of a traditional name such as "stocks" or "bonds" will lead a purchaser justifiably to assume that the federal securities laws apply. This would clearly be the case when the underlying transaction embodies some of

the significant characteristics typically associated with the named instrument..
421 U.S. at 850-851

In further support of the view that a device, no matter what its name, must meet the definition of "an investment of money in a common enterprise with profits to come solely from the efforts of others," the Court in Forman said "we perceive no distinction, for present purposes, between an 'investment contract' and an 'instrument commonly known as a security.'" 421 U.S. at 852. The Court goes on to say:

This test, in shorthand form, embodies the essential attributes that run through all the Court's decisions defining a security. The touchstone is the presence of an investment in a common venture premised on a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others.... In such cases the investor is 'attracted solely by the prospects of a return' on his investment By contrast, when a purchaser is motivated by a desire to use or consume the item purchased - 'to occupy the land or to develop it themselves,' as the Howey court put it, *ibid.* - the securities laws do not apply. [421 U.S. at 852-853]. (emphasis added).

By that definition and that discussion it is clear that the investment made by the plaintiff in this case does not come under the Act. He was not seeking a profit or return solely

from the "entrepreneurial or managerial efforts of others." Instead, he bought himself a job with the company and assumed an official position as executive vice-president with a 50-50 managerial right. To use the phrase of the Supreme Court in Forman, "the securities laws do not apply."

Plaintiff points out that even though Howey stressed the language "solely the work of others," the Ninth Circuit Court of Appeals in S.E.C. v. Glen W. Turner, Inc., 474 F. 2d 476 (9th Cir. 1973) refused to bar the plaintiffs from their Securities Act claim merely because they had to exert substantial effort of their own to obtain a profit. The Court held that the word "solely" should not be applied mechanistically so that any effort or work by the investor, no matter how slight, would remove the investment from the coverage of the Act. The Ninth Circuit adopted what is considered a more realistic test: "Whether the efforts made by those other than the investor are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise." 474 F.2d at 482.

This test may not be as easy to apply as it is to formulate. In most business enterprises the managerial efforts of several persons,

as a practical matter, "affect the failure or success of the enterprise." An investor who also becomes a part of management should not be able to claim the protection of the Act merely because others in the common enterprise exert essential managerial efforts which affect the failure or success of the enterprise. If the investor-manager participates in those managerial efforts then even the Turner gloss on the word "solely" would not bring the investment within the coverage of the Act.

Indeed, the facts in Turner show that the investor there had no management duties at all. Each investor was a promotor of his own pyramid empire but the money he invested was in a corporation controlled wholly by others. A Chevrolet dealer who buys stock in General Motors would not be precluded from protection of the Act merely because his efforts (indeed managerial efforts) affect the failure or success of General Motors.¹ But one who purchases a one-half interest in a corporation, who devotes his full time and effort to its corporate affairs, who assumes and accepts the position of executive vice-president and who serves in that capacity for a substantial period of time cannot be said

to be depending "solely" on the efforts of others to realize on his investment.

-
1. The word "affect" has no life or death connotations. Every sale of a Chevrolet (or failure to sell) affects the success (or failure) of General Motors.

In the absence of federal question jurisdiction under the securities laws the pendent jurisdiction over the remaining counts of the complaint falls. It is appropriate, however, to paraphrase the Supreme Court in part three of its Forman decision:

In holding that there is no federal jurisdiction, we do not address the merits of [plaintiff's] allegations of fraud. Nor do we indicate any view as to whether the type of claims here involved should be protected by federal regulation. We decide only that the type of transaction before us, in which the purchasers [assumed a substantial and significant managerial position in the enterprise], is not within the scope of the federal securities laws. [421 U.S. at 859-860].

Accordingly, the complaint will be dismissed.

An appropriate order shall issue.

United States District Judge

Date: 28 July 1977

PUBLISHED

UNITED STATES COURT OF APPEALS
FOR THE FOURTH CIRCUIT

NO. 77-2360

Richard E. Coffin,

Appellant,

v.

Polishing Machines, Inc.
John A. Tricoli, Jr., Helen Tricoli,
and Nicholas Daniels,

Appellees.

Appeal from the United States District Court for the Eastern
District of Virginia, at Richmond. D. Dortch Warriner, District
Judge.

Argued: February 6, 1979

Decided: April 25, 1979

Before HAYNSWORTH, Chief Judge, BUTZNER and WIDENER,
Circuit Judges.

Stuart W. Settle (John C. Moore, Coates, Comess, Settle, Moore
& Taylor on brief) for Appellant; Michael S. Shelton (W.H.C. Venable,
Cohen, Abeloff & Staples, P.C. on brief) for Appellees.

BUTZNER, Circuit Judge:

Richard E. Coffin sued in the district court to recover compensatory and punitive damages for misrepresentations allegedly made to him in connection with his purchase of stock in Polishing Machines Systems, Inc. The district court dismissed the action for lack of federal jurisdiction and for failure to state a claim upon which relief could be granted. We reverse and remand..

I

Coffin's complaint alleges the following facts. Polishing Machines is a Virginia corporation that sells commercial car waxing and polishing equipment. John Tricoli, president of the company, visited Coffin's New York service station late in 1975 in order to interest Coffin in the company's products. As a result of the visit, Coffin became an area distributor for the company. Tricoli then gave Coffin a copy of a report describing the company and encouraged him to consider purchasing stock that the company wanted to sell in order to finance expansion. After negotiations in Virginia and New York, the parties reached an agreement. Their written contract provided that Coffin would

buy half of the outstanding shares in Polishing Machines, sell his service station, move to Virginia, and devote his full time to duties as executive vice president of the corporation.

Pursuant to the contract, Coffin sold his business and began work at Polishing Machines in May, 1976. The stock that he purchased had all of the attributes of ordinary common stock.

After gaining access to the company's books, Coffin learned that representations made to him in the report and during the negotiations were materially false and misleading. Specifically, he discovered that Tricoli had converted corporate assets to his own use and left Polishing Machines insolvent. Coffin then brought this action in the district court to recover damages under the federal securities acts, the Virginia blue sky statute, and the common law of fraud.

The district court granted motions under Federal Rule of Civil Procedure 12(b)(1) and (b)(6), dismissing the case on its pleadings. The court relied on *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837 (1975), for the proposition that not every sale of stock falls within the coverage of the federal securities statutes. It then reasoned that even ordinary corporate stocks are not securities within the meaning of the federal statutes unless they "represent an interest

in an enterprise from which the investor seeks to derive a profit solely from the work of others” See SEC v. Howey Co., 328 U.S. 293, 298 (1946). Since Coffin was to contribute substantially to the management of Polishing Machines, the court held that the substance of the transaction in this case was the sale of a half interest in a business even though the transfer took the form of a sale of stock.

II

We do not believe that Forman denies a purchaser of ordinary corporate stock the protection of the federal securities laws simply because he intends to participate in the management of the corporation in which he invests. Both the Securities Act of 1933, 15 U.S.C. § 77b(1), and the Securities Exchange Act of 1934, 15 U.S.C. § 78c(a)(10), include “stock” within their definitions of a “security.” Thus, when a transaction involves stock, there is a strong presumption that the statutes apply. Occidental Life Insurance Co. v. Pat Ryan & Associates, Inc., 496 F.2d 1255, 1261 (4th Cir. 1974). Forman requires us to analyze the substance of a transaction only when the stocks involved do not have the “significant characteristics typically associated with the named

instrument.” See Forman, 421 U.S. 837, 850-51.

Absent some showing that ordinary corporate stocks are other than what they appear to be, we need not consider whether an investor will derive his profit partly from his own efforts. That test, drawn from SEC v. Howey Co., 328 U.S. 293, 298 (1946), applies to interests not easily recognized as securities in the capital market. It does not apply to stock that comes within the clear language of the securities acts. The court in Forman, for example, applied the Howey test only after deciding that the shares under consideration were not like ordinary capital stock. See Forman, 421 U.S. 837, 850-53; Bronstein v. Bronstein, 407 F. Supp. 925, 929-30 (E.D. Pa. 1976).

When ordinary corporate stock is involved in a transaction, we likewise need not consider whether the parties could have structured their arrangement in some other form. The parties in this case chose to implement their plan for joint ownership by means of a stock transfer rather than a partnership agreement or a sale of assets. Having decided to deal in stock, they brought their transaction under the provisions of the federal securities statutes. Occidental Life Insurance Co. v. Pat Ryan & Associates, Inc., 496 F.2d 1255, 1263 (4th Cir. 1974). Indeed, the descriptive report supplied to Coffin during the negotiations

Supreme Court, U. S.

FILED

AUG 17 1979

MICHAEL RODAK, JR., CLERK

IN THE
Supreme Court of the United States

OCTOBER TERM, 1979

NO. 79-115

POLISHING MACHINE SYSTEMS, INC.

JOHN A. TRICOLI, JR.

HELEN TRICOLI, and

NICHOLAS DANIELS,

Petitioners,

V.

RICHARD E. COFFIN,

Respondent.

BRIEF IN OPPOSITION TO
PETITION FOR WRIT OF CERTIORARI

TO THE UNITED STATES COURT OF APPEALS
FOR THE FOURTH CIRCUIT

Stuart Williston Settle, Jr.

John C. Moore

COATES, COMESS, MOORE,

TAYLOR & GRUBBS

200 West Franklin Street

P. O. Box 12244

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(804) 643-6621

Counsel for the Respondent.

SUBJECT INDEX

	Page
Table of Authorities	ii
Statement of the Issue Presented For Review	1
History of Proceedings Below . . .	1
Statement of Material Facts . . .	2
Reasons for Denying the Writ . . .	3
Conclusion	6
Certificate	7
Appendix	9

TABLE OF AUTHORITIES

Coffin v. Polishing Machines, Inc., 596 F.2d 1202 (4th Cir. 1979) . . .	3
Occidental Life Insurance Co. v. Pat Ryan & Associates, Inc. 496 F.2d 1255 (4th Cir. 1974) . . .	5
Securities and Exchange Commission v. Howey Co., 328 U.S. 293 (1946)	4,7
United Housing Foundation v. Forman 421 U.S. 837 (1975)	4,7
Statutes	
Securities Act of 1933, 15 U.S.C. §77 (1971).	1
Securities and Exchange Act of 1934, 15 U.S.C. §78 (1971).	1

STATEMENT OF THE
ISSUE PRESENTED
FOR REVIEW

The issue presented to the Court for review is whether the verified complaint filed in the District Court by the respondent (the "Plaintiff" or "Coffin") states a cause of action under the Securities Act of 1933, 15 U.S.C. §77 (1971) and the Securities and Exchange Act of 1934, 15 U.S.C. §78 (1971) (collectively the "Securities Acts") by virtue of the allegation of a fraudulent sale of common stock possessing all the attributes of ordinary common stock.

HISTORY OF PROCEEDINGS
BELOW

The petitioners' statements of opinions below, jurisdiction, statement of the case and rulings below are substantially correct.

STATEMENT OF MATERIAL FACTS

The petitioners' statement of material facts is substantially correct. However, the petitioners neglect to mention that in their inducement of Coffin they made use of a prospectus or offering circular entitled "A Descriptive Report Polishing Machine Systems, Inc. Petersburg, Virginia" (the "Report"). The Report was undated, but had apparently been prepared a year or two before its showing to Coffin as a sales tool to bring in additional outside capital to the corporate petitioner, Polishing Machine Systems, Inc. (PMS) in connection with a planned expansion of the company. In his complaint Coffin alleged reliance on representations made in the Report, which he later learned to be materially false and misleading.

While the District Court made

no mention of the Report in its memorandum opinion of July 28, 1977 (Petition Appendix I p. 17), the Court of Appeals held the Report indicative of PMS' desire to sell its stock to finance its planned expansion. Coffin v. Polishing Machines, Inc., 596 F.2d 1202, 1204 (4th Cir 1979) (Petition Appendix II p. 18). The Report has been reproduced as an appendix to this brief.

REASONS FOR DENYING THE WRIT

In urging the granting of a writ in this case the petitioners are unable to invite the Court's attention to conflicting authority from other Circuit Courts of Appeal because a search of the cases will disclose no support for the novel proposition they are here asserting that shares of common stock in a corporation organized for profit are not securities within the definitional sections of the Securities Acts. The petition stacks

the holding of this Court in United Housing Foundation v. Forman, 421 U.S. 837 (1975), on top of Securities and Exchange Commission v. Howey Co., 328 U.S. 293 (1946), to justify the assertion that when a shareholder becomes an active participant in the business as opposed to one merely passively investing his money with others in the anticipation of making a profit, he will be denied the protection of the Securities Acts.

Such an analysis was rightly rejected by the Court of Appeals which distinguished the Forman case by noting that although the instruments there involved were called "stock" they did not possess the attributes commonly associated with stock in a commercial sense. The Court of Appeals further determined that only after deciding that the shares in Forman were not stock in a commercial sense of the word did the Howey test of whether

the investor stood to profit from his own efforts or solely from the efforts of others apply. Coffin submits that the analysis of the Court of Appeals is consistent with the purpose and history of the Securities Acts, and provides a bright-line test that can be applied in all stock transactions where fraud is involved, whether the offerings and sales are of small amounts of shares to a multitude of investors, a substantial interest in the business with concomitant rights of membership on the board of directors and an office in the company, such as Coffin here received, or the sale of an entire business -- lock, stock and barrel. See Occidental Life Insurance Co. v. Pat Ryan & Associates, Inc., 496 F.2d 1255 (4th Cir. 1974).

To apply the test formulated by the petitioners to the shares of PMS would mean that those shares of stock

are not "securities" because half of them were sold in a block to one improvident purchaser. If, on the other hand, the Report had been used by petitioner Tricoli in soliciting the sale of the same number of PMS shares to eight dentists from Short Hills, New Jersey, the same would by some ontological process be transubstantiated into "securities". Once such a standard were adopted each trial court would have to determine what percentage interest in the shares of a company was necessary to confer an opportunity on a purchaser to become actively involved in the management of the business; Coffin submits that such determinations would be better made by metaphysicians than by federal district judges.

CONCLUSION

In a case such as this where fraud is alleged in the offering and subsequent sale of common stock in a busi-

ness corporation the Howey test of passive investment has no applicability, because the stock falls within the clear definition of a security as defined in the Securities Acts, and the Forman test is inapplicable because the interest there alleged to be a security was not possessed of the attributes recognized of stock in the capital marketplace. Accordingly, the petition for writ of certiorari should be denied.

Respectfully submitted,

Stuart Williston Settle, Jr.
Stuart Williston Settle, Jr.
John C. Moore
COATES, COMESS, MOORE, TAYLOR &
GRUBBS
200 West Franklin Street
P. O. Box 12244
Richmond, Virginia 23241

Dated: August 10, 1979

CERTIFICATE

I hereby certify that on the 17th day of August, 1979, three copies of the foregoing respondent's brief in opposition to the granting of a writ of certio-

rari were hand-delivered to Michael S. Shelton, Esquire, COHEN, ABELOFF & STAPLES, P. C., 207 West Franklin Street, Richmond, Virginia, 23220, counsel of record for the petitioners herein, prior to the filing of same with the Clerk of this Court.

Stuart Williston Settle, Jr.
Stuart Williston Settle, Jr.

APPENDIX

A DESCRIPTIVE REPORT
POLISHING MACHINE SYSTEMS, INC.
Petersburg, Virginia

POLISHING MACHINE SYSTEMS, INC.

Petersburg, Virginia

---A DESCRIPTIVE REPORT OF OUR---

... CORPORATE STRUCTURE

... OUR PLANS

... OUR OBJECTIVES

Table of Contents

<u>Phase I</u>	The Company and its History
	Capitalization
	Business
	Method of Marketing
	Executive Offices and Real Es- tate
	Present Officers and Directors
	Accounting
	Financial References
	Legal
	Sales and Earnings
	Trade References
<u>Phase II</u>	Expansion and Projection:
	a) Lease-rental of Equipment

b) MOBIL CAR-CARE CENTERS

Competition

Use of Proceeds and Sources of
Funds

THE COMPANY AND ITS HISTORY

The company was founded in July of 1969 by John A. Tricoli, Jr. who presently is President and Chairman of the Board of Directors. POLISHING MACHINE SYSTEMS, INC. was incorporated in the Commonwealth of Virginia on February 6, 1970. While the charter of the company provides for wide diversification, the company was formed principally for the purpose of distributing High-Speed automobile polishing machines along with the company's line of private label waxes, chemicals and supplies.

CAPITALIZATION

The capitalization of the company was set at 300,000 shares authorized at \$1.00 par value. At present there are

two

49,500 shares issued and outstanding, for all of which the company has received at least \$1.00 per share in cash.

BUSINESS

The company distributes nationwide a High-Speed automobile polishing machine patented by Gem Industries of Livingston, New Jersey. This machine is manufactured primarily for the company by Littlestown Hardware and Foundry, located in Littlestown, Pennsylvania. The company has developed a system around the High-Speed machine consisting of waxes, chemicals, supplies, advertising material and both indoor and outdoor signs. The system enables company's customers to Simoniz polish most any automobile in 30 minutes or less featuring Simoniz paste wax. The company has successfully developed the fastest paste waxing system for the exterior of automobiles presently existing today through-

three

out the country. In the first four years of business the company has distributed over 2,500 units to more than 1800 accounts. The company sells reorders of waxes, chemicals and supplies to all of its present customers. The unit sells for a list price of \$595.00 per kit.

METHOD OF MARKETING

The company uses direct mail as its primary source of inquiries.* Mailings are made to: Service Stations, Car Washes, New Car Dealers, Used Car Dealers and Auto Reconditioning Centers. Certain areas of the country are predetermined and then mailed. When an adequate number of inquiries are received, the company deploys teams (usually 2-man teams) in company owned van trucks containing a supply of complete sales-kit units to contact and qualify the prospects. A demonstration of the system is set up at the

*See Exhibits 1 and 2

four

prospect's place of business, and the sales presentation is made at this time. The company experiences a very high percentage of sales per demonstration-averaging about 70%. This high percentage is due to the rapid speed of the equipment and quality of finished job. The company offers the ultimate in the industry. The waxes and chemicals are comparable to the best on the market-headed by none less than the actual "Simoniz Super Blue".

EXECUTIVE OFFICES AND REAL ESTATE

The company on March 25, 1973, purchased approximately 1.2 acres of land and a building approximately 6000 square feet located at 2058 County Drive (Rte 460 East), in Petersburg, Virginia. To date, including improvements, the company's investment is approximately \$105,000.00. A mortgage due the United Virginia Bank is about \$63,000.00.

The company presently leases

five

three sections of the building producing an annual rent income of about \$19,500.00.

The cost of principal, interest, and taxes amounts to \$9,250.00 per annum.

The company intends to add on to the present building as soon as mortgage money rates become realistic and available.

Additions obviously will add to present income. The building and land proximity is prime in that Interstates 1-95, 1-85, US 460 East and US 301 all intersect in the immediate area. Also, US 460 East is presently the main artery between the Tri-Cities of Petersburg, Colonial Heights and Hopewell and the Norfolk-Virginia Beach area.

PRESENT OFFICERS, DIRECTORS AND STOCK-

HOLDERS

Name/Address

John A. Tricoli, Jr.
Resident and Homeowner
1206 Wellington Road
Colonial Heights, Virginia

six

Office

Shares Owned

President/Director 29,500

William L. Hiltner
Resident and Homeowner
Franklin Farms
Prince George, Virginia

Secretary/Treasurer 4,500
Director

Mark T. Lerche
Resident and Homeowner
1935 North Westchester Dr.
Petersburg, Virginia

Vice-President 15,500
Director

ACCOUNTING

The books and records of the company are maintained at the main office in Petersburg, Virginia. H. L. Blount & Co. had provided the accounting services from inception through the fiscal year ending June, 1973. Effective July 1, 1973, Carl W. Wells, Business Consultant and Book-keeping, has been retained to handle the company's accounting needs. At present, all Federal and State taxes are current including the Corporate Franchise Tax;

seven

all real estate taxes are current.

FINANCIAL REFERENCES

The company banking and financial needs are conducted at:

United Virginia Bank-Petersburg, Virginia

The Bank of Virginia-Petersburg, Virginia

THE BANK OF VIRGINIA

From 1969 through 1972, the company and officers had several loans amounting to approximately \$15,000.00, all of which are paid in full. The company presently maintains a checking account there.

UNITED VIRGINIA BANK

From mid 1969 to present, the company and officers have borrowed money of approximately \$100,000.00 or more. Current loan commitments amount to \$13,800.00 in annual payments. At present all company loans and payment commitments are in good standing, and are paid on time. The company maintains a

eight

checking account here.

LEGAL

Since the inception of the company, there has never been any litigation, leins, suits or claims against the company. Nicholas Daniels, Esquire, of Petersburg, Virginia, represents the company in matters requiring legal guidance.

SALES AND EARNINGS

The company, during the first fiscal year of operation, had sales of \$149,854, including cash and accounts receivables. Each consecutive year since has increased the cash sales. The company has never lost money, with the exception of pre-organization and start-up expenses which has been carried forward, resulting in tax credits for the first four years of business. However, all the tax credits have been exhausted, resulting most likely in a sizable tax payment structure in the future of normal corpo-

nine

rate tax payment bracket.

During the first four years of business, the company, due to conservative and well managed operations, has reduced liabilities to a minimum by operating on a "pay as you go" program rather than credit. Current liabilities are at an all time low. Management's guiding principal of business conduct has been "if you can't buy and pay for it-then don't sell it". However, right or wrong, this practice has paid off for the company for the first phase of operations.

TRADE REFERENCES

The company purchases machines, waxes, chemicals and supplies from the following:

Gem Industries-Livingston, New Jersey
Littlestown Hardware & Foundry-Littles-
town, Pennsylvania
Texize Chemical-Simoniz Division-
Atlanta, Georgia

ten

Ren Hill Products-Irvington, New Jersey
Gamarel Electric-Irvington, New Jersey
Nation Assessories-Brooklyn, New York
Ernest Lockett Signs-Petersburg, Virginia
Modern Sign Co.-Birmingham, Alabama
Owen Printing Co.-Petersburg, Virginia
B & P Offset-Petersburg, Virginia

The above list represents the company's primary suppliers; all accounts are presently maintained on a current basis or paid in full. Over the past four years of operation, the company has enjoyed an excellent relationship with all of its suppliers.

ADDITIONAL TRADE AND CREDIT REFERENCES

The company and officers maintain presently the following list of credit cards which are necessary to do business with due to the extensive traveling throughout the country:

American Express, Diners Club,
Carte Blanche, Bank Americard, Master
Charge, Exxon, Gulf Oil, Texaco, Shell

eleven

Oil, Sunoco, American Oil Co., Phillips
66, Union 76, ARCO, CITGO.

All credit card accounts are maintained
on a current basis and in good standing.

EXPANSION AND PROJECTIONS

Management is actively engaged
in implementing the SECOND PHASE of
operation. The addition of two new
divisions will deal with the same pro-
ducts but will add a wide line of addi-
tional equipment:

A) Leasing of equipment

B) Mobile Care Care Centers

By entering into these two new fields,
management is confident that a tremen-
dous amount of sales and earnings will be
realized.

A) LEASE-RENTAL OF EQUIPMENT

The company, in addition to direct
sales, is planning to lease or rent
the basic machines under the follow-
ing conditions:

twelve

- 1) \$100.00 security deposit
- 2) \$25.00 rent per month
- 3) Direct cash sales of supplies

If the equipment is marketed under
these conditions, the security depo-
sit will more than cover the company
costs in event of failure to receive
payments. The cash sale of supplies
will result in an immediate profit,
based on sale of a full kit of
\$165.00 selling price. The company
would realize approximately \$115.00
gross cash profit. This gross cash
profit will more than sustain the
over-all operation. The security
deposit will protect any loss result-
ing from default in lease or rental
payments on an all-profit basis.

Based on this theory, management es-
timates that 1000 units leased or
rented would result in an income of
\$25,000.00 per month, resulting in
hundreds of thousands in annual pro-

thirteen

fits. However, increased costs in collection, bookkeeping and inventory controls are anticipated but unknown at this time. All lease contracts would have a minimum period of six months. Basically, rather than having to sell equipment for cash to dealers with limited financing, the company would be in a position to set up our average dealer for far less money than ever before. Results, unquestionably, will be many more sales.

B) MOBILE CAR-CARE CENTERS

During the past 18 months, the company has been analysing [sic] the feasibility of entering into the Mobile Car-Care Center business. Realizing the need for a low overhead reconditioning center, the company has planned a complete car-wash and car-polishing center on WHEELS. All of the required machines, equip-

fourteen

ment, waxes, chemicals and supplies are installed in a van truck; work is done on the spot. Management estimates that the equipment is capable of producing \$65.00 per hour using a two-man team. The company intends to engage in an active mailing and advertising program to solicit inquiries, upon which the company will demonstrate and fully train these men on the complete use of the system. A training center will be needed at the company's home office. The selling price is presently set at \$3,500.00 per unit (the company cost ranges just at \$1,000.00). The truck vans will be leased and the lease cost will be passed on to the purchaser. Realizing that the company for the past four years has traveled all over the country, one must thoroughly acknowledge the fact that

fifteen

the company has become expertise in auto clean-up field. It is presently the opinion of the company that the Mobile Car-Care Center, fully equipped, will sell at a very brisk pace.

COMPETITION

At present there isn't any competition in this field on a nationwide basis. Management is very optimistic and enthusiastic for the high growth potential of the MOBILE CAR-CARE CENTER.

USE OF PROCEEDS AND SOURCES OF FUNDS

The company, in order to add the two expansion programs, has estimated the need of approximately \$150,000.00. The intention is to raise the necessary funds from the sale of 50,000 shares of common stock.

The funds will be used in the following manner:

A) Lease-rental operation

sixteen

1) Addition of 500 complete units to present inventory.

2) Addition of 10 new sales representatives.

3) Addition of 10 vehicles.

4) Addition to present mailing and advertising.

B) Mobile Car-Care Center

1) Starting inventory of 10 complete van trucks-set up with complete Car Care equipment.

2) Create Car Polishing Training Center.

3) Expanded advertising and mailing program.

4) Addition of following personnel-

a/ Training Instructor
b/ Demonstrators

C) All remaining funds to be used as additional working capital.

seventeen